BlueCross BlueShield Association

An Association of Independent Blue Cross and Blue Shield Plans

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The Honorable Gennet Purcell
Commissioner
Department of Insurance, Securities, and Banking
810 First Street, NE
Washington, D.C. 20002

Dear Commissioner Purcell:

I am writing to provide the perspective of the Blue Cross and Blue Shield Association (BCBSA) to assist you in your examination of the reserve levels maintained by Group Hospitalization and Medical Services, Inc. (GHMSI), the Blue Cross and Blue Shield licensee domiciled in the District of Columbia. By way of introduction, the BCBSA is the owner of the BLUE CROSS® and BLUE SHIELD® Brands as well as the trade association and licensing organization for the 39 independent Blue Plans that collectively provide healthcare coverage for 100 million – nearly one in three – Americans. The Association is headquartered in Chicago, with offices in Washington, D.C. (In fact, the health coverage for many of our Washington-based associates is provided by GHMSI.)

The BCBSA is aware of the Department of Insurance, Securities, and Banking's recent Adequate Surplus Determination which finds that, under the terms of The Medical Insurance Empowerment Amendment Act of 2008, GHMSI's reserves are "greater than the appropriate risk-based capital requirements" and sets a hearing on September 10-11, 2009 to determine whether the portion of the surplus attributable to the District is "excessive." The Department specifically stated that its Determination "is not meant to suggest that the statutory and BCBSA minimum RBC levels . . . should be deemed advisable for GHMSI or that they are adequate or sufficient to meet GHMSI's insurance and other needs." As explained in detail below, the BCBSA agrees that the minimum RBC levels referenced in the law have absolutely no bearing on, and should not be considered in evaluating whether, GHMSI's reserves are "excessive" under the law.

## *1. BACKGROUND ON BCBSA'S MONITORING OF PLANS*

As owner and licensor of the Blue Brands, BCBSA continually monitors the operating performance and financial condition of each of its 39 Plans, which must submit quarterly financial reports and semi-annual Health Risk-Based Capital (HRBC) reports to BCBSA. Many metrics from these financial reports, including the HRBC ratio (i.e., Total Adjusted Capital divided by the Authorized Control Level RBC), are monitored by BCBSA to assess the financial condition of the Plans. BCBSA utilizes a Plan's HRBC ratio among other measures to determine the need for various monitoring and licensure actions, and to exempt Plans from certain licensure compliance requirements.

Initial inclusion in intensified monitoring (also known as the "Early Warning" stage) occurs when a Plan's HRBC ratio falls below 375 percent. However, in every case, BCBSA considers the Plan's current and projected HRBC ratio as well as the specific circumstances of the situation..

In order to retain its license from BCBSA to use the BLUE CROSS® and/or BLUE SHIELD® Brands, a Plan must maintain an HRBC ratio of at least 200 percent, the "Licensure Minimum" capital requirement. If a Plan's HRBC ratio were to fall below 200 percent, BCBSA's Board of Directors (composed of the CEOs of the Plans) would commence actions to terminate that company's license to use the Blue Brands. BCBSA intentionally set its minimum capital requirement at the same point as the highest of the four Levels of Action under the NAIC's Risk-Based Capital Model Act. As the owner of the Blue Brands, BCBSA wants to ensure that its Brands carry a clear connotation of financial strength and brand integrity. We believe this goal would be compromised if a BCBSA-licensed company's capital level were to fall below the NAIC's Company Action Level.

## 2. GHMSI's CAPITAL IS MAINTAINED FOR ONE PURPOSE

Blue Cross and Blue Shield companies maintain strong financial capital for one purpose – to ensure their ability to pay members' medical claims in good times and bad times, including widespread crisis situations such as a major disaster, terrorist event or epidemic. Blue Plans must be prepared to provide their members with rock solid assurance that their health insurance coverage remains in place and claims will be paid, no matter what the circumstance. The ability of Blue Plans to meet their obligations to their policyholders, even in the current difficult economy, is not an accident. Maintaining strong capital over time – well beyond minimum levels – protects our customers and is good for the communities we serve.

## 3. RISK-BASED CAPITAL IS NOT A MEASURE OF EXCESS CAPITAL

The NAIC designed the Health Risk-Based Capital (HRBC) formula solely for the purpose of assessing whether an insurer is inadequately capitalized. As noted above, the BCBSA makes use of HRBC in its monitoring and compliance programs and utilizes HRBC-based thresholds to establish minimum requirements.

BCBSA fundamentally disagrees with the premise that reserves can be determined to be "excessive" solely or substantially on an insurer's HRBC ratio. This approach is contrary to the NAIC's intent when it developed the risk-based capital formula. HRBC is a retrospective formula based on industry-wide assumptions. By design, HRBC does not incorporate such factors as the insurer's environment and company-specific business risks, future infrastructure needs, strategies, growth plans or investment needs. When the risk-based capital standard for health insurers was being designed in the early 1990s, the NAIC repeatedly stated that risk-based capital ("RBC") represents a minimum acceptable level of capital rather than a maximum level of capital:

> "The [Life RBC Working Group] discussed problems associated with using RBC results for other purposes...Tying other regulatory provisions to surplus amounts above the RBC thresholds is problematic in that the formula was not developed to measure financial strength or capital adequacy beyond a minimum regulatory requirement.[1]
>
> "The formula that is proposed is a threshold capital formula rather than a target capital formula. It has been designed to identify companies with capital levels that require regulatory attention. The formula has not been designed to differentiate among adequately capitalized companies.
>
> "Therefore, it would be entirely inappropriate to use this formula to rate or rank adequately capitalized companies."[2]

Shortly after the NAIC risk-based capital standard was implemented, the position that the NAIC RBC formula is wholly unrelated to the issue of the appropriate level of capital for an insurance company was reinforced in an NAIC-published journal article co-authored by the NAIC's then-director of research:

> "The NAIC RBC formula was designed to establish a regulatory minimum level of capital based on risk...These new risk-based capital standards do not set a target capital level or even an optimal capital level...Companies are free to hold capital above and beyond the minimum level established by the RBC formula, and virtually all companies do, but the exact level of capital is an internal business decision outside the scope of regulatory monitoring. That optimum capital level chosen by the company can be well outside the company action level RBC determined by the NAIC formula...[I]t is important to appreciate that the RBC formula should not bind an adequately capitalized firm."[3]

In conclusion, the NAIC has made it clear that the specific purpose of its HRBC formula is as a tool for assessing insurer solvency, and that the HRBC formula was neither designed nor intended to be

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[1] NAIC Proceedings 1993 3rd Quarter, page 228.

[2] NAIC Proceedings 1992 4th Quarter, page 557.

[3] Robert W. Klein and Michael M. Barth, "Solvency Monitoring in the Twenty-First Century," *Journal of Insurance Regulation*, Vol. 13, No. 3, 1995, page 274.

used as a metric for determining an insurer's target or maximum capital level, or as a basis of public policy funding.

### 4. THE NEED FOR CAPITAL MUST CONSIDER GHMSI'S UNIQUE CIRCUMSTANCES AND BUSINESS REQUIREMENTS

A Blue Plan's capital needs should be determined by evaluating a variety of factors, some of which are included in the HRBC formula, but others of which are not included, such as the competitive environment, expected growth of benefit costs and future business plans and strategies. For example, GHMSI operates in an extremely limited geographic area and includes a book of business that comprises a higher concentration of risk business (67%) than the Blue System (58%). This limits the ability of GHMSI to spread its risk over a broader base, making it relatively more vulnerable to local risks, such as epidemics, severe weather calamities and terrorist acts, none of which should be considered unlikely to occur, particularly in the District.

Additionally, not-for-profit health Plans such as GHMSI have only one source of obtaining capital and that is by generating net gains. Because their access to capital is limited and margins are slim (in 2008 GHMSI's net gain as a percent of net revenue was 1.1%), they need to maintain strong reserves to meet their obligations to members, providers and the community.

These risks are not accounted for in the HRBC formula, but are taken into account by independent rating agencies when assessing financial strength and assigning ratings. Capitalization (i.e., the capital position, balance sheet strength, statutory surplus growth, etc.) is a key metric the rating agencies consider when evaluating a not-for-profit Blue Plan. Strong capitalization enhances their strategic flexibility since sources of funds are primarily internally generated whereas for-profits have the added option of accessing public equity markets to build capital.

BCBSA believes that it is appropriate and prudent for GHMSI to hold a level of capital significantly beyond what might otherwise be expected to provide the greatest possible assurance that policyholders' benefit claims will be paid and those reserves should not be viewed by the District as a fund for purposes that are unrelated to protecting policyholders. To this end, BCBSA requires its licensees to maintain capital levels significantly above the minimum required by most states' insurance regulations. Failure to meet this requirement could result in the loss of GHMSI's right to use the Blue Brands. Among the implications of such an event would be the movement of approximately 350,000 Blue National Account and Federal Employee members away from GHMSI to a Blue Plan in another area and the loss of beneficial BCBSA programs to GHMSI and its policyholders, including access to more than 500,000 participating providers in worldwide Blue networks, as well as valuable "hold harmless" protection, medical services without up-front payments, away-from-home care, and access to the Blue System's transplant and Blue Distinction networks.

### 5. "ATTRIBUTING" RESERVES TO ANY SINGLE JURISDICTION IS INAPPROPRIATE

In monitoring the financial strength of Blue Plans, the BCBSA considers each Plan in its entirety. Attempting to evaluate appropriate levels of reserves "attributable" to any single political jurisdiction within a Plan therefore is logically and practically impossible. The HRBC ratio evaluative tool is based upon the overall risks faced by the organization as a whole, never on a jurisdictional basis. As such, the BCBSA questions the very task before you, e.g., whether attempting to evaluate whether that portion of GHMSI's reserves that are *attributable to the District* are excessive can even be done in any actuarially sound way. We are not aware of an instance when such an evaluation has even been attempted. Like any multi-jurisdictional insurer, GHMSI maintains reserves for the protection of its members in all of the jurisdictions it serves. Those reserves exist to protect and cover members in all jurisdictions as needs arise and cannot be divided among those jurisdictions.

Because it is not possible to attribute GHMSI's reserves to a single jurisdiction, we are sending this letter to the Maryland and Virginia regulators to assure that they are aware of our concerns.

### 6. CONCLUSION

Although BCBSA does make extensive use of the HRBC ratio methodology, we firmly believe that it is important to recognize that HRBC has its limitations as an analytical tool, and that there are many

metrics besides HRBC that are relevant to management and regulators in making assessments relating to capital levels. HRBC was designed solely for the purpose of assessing whether an insurer is inadequately capitalized, and it is ill-suited to the task of assessing whether a financially healthy insurer's capitalization level is optimal or excessive.

In particular, BCBSA fundamentally disagrees with the establishment of maximum capital levels based solely or substantially on an insurer's HRBC ratio and believes that this would be contrary to the NAIC's intent when it developed the risk-based capital formula. RBC is strictly a retrospective metric based on industry-aggregate assumptions. By design, it does not incorporate such factors as the insurer's company-specific business risks, future strategies, growth plans or investment needs.

The NAIC clearly has said that the specific purpose of the HRBC formula is as a tool for assessing insurer solvency, and that the HRBC formula was neither designed nor intended to be used as a metric for determining an insurer's target capital level or maximum capital level. BCBSA's use of the HRBC ratios adheres to these intentions of the NAIC. BCBSA utilizes HRBC-based thresholds to establish minimum requirements but never to establish maximum requirements.

Finally, the BCBSA strongly objects to any law that unfairly applies only to a BCBSA-licensed company.[4] The law imposes requirements only on GHMSI and not on any other for-profit or non-profit health insurer or HMO, administrator or health care provider operating within the District. The potentially punitive outcome that this process creates for GHMSI only serves to weaken it, a result that is in no one's interest and which could be counter-productive if GHMSI's capital level were to deteriorate. I appreciate this opportunity to provide the BCBSA's perspective on this matter.

Sincerely,

Scott P. Serota

cc: Hon. Alfred W. Gross
Commissioner
Virginia State Corporation Commission

Hon. Ralph S. Tyler, III
Commissioner
Maryland Insurance Administration

[4] Although the MIEAA applies to any health service corporation, GHMSI is the only such corporation currently active in the District.